

Many Shades of Green

Disclosure Documents in Green Bond Offerings



Gregory Miller | Bickerstaff Heath Delgado Acosta LLP
3711 S. Mo-Pac | Building One | Suite 300 | Austin, TX | 78746
Office 512.472.8021 | Direct 512.404.7762 | Fax 512.320.5638
GMiller@bickerstaff.com | www.bickerstaff.com

A New Type of Municipal Security

Green bonds are a relatively new category of debt that presently accounts for only a small volume of overall securities transactions. Although the global green bond market is expected to reach a record \$250bn for the year 2018, it still represents less than 1% of the total fixed-income market. In the U.S., green municipal issuances are only about 2% of total municipal issuance. By the same token, however, the idea of green bonds is generating considerable discussion and interest among public finance professionals. The level of attention green bonds are receiving is noteworthy given that the public finance community typically – with good reason – tends to view any innovation in financing with a cautious eye. Perhaps even more notably, green bonds are generating this high level of interest despite the fact that there is no universally accepted definition, much less any specific regulatory scheme that covers these instruments.

If you are considering whether your agency or entity might want to issue green bonds to finance any of your upcoming projects, nothing can substitute for the guidance of your financial advisor to evaluate the feasibility of the financing and whether it makes economic sense for your agency and for your constituents. Additionally, you will need to consult with the engineers and planning experts within your organization to assess the viability of the project to be funded, its environmental impacts, and the project’s relationship to your organization’s overall environmental goals.

After this initial assessment, moving forward with financing or refinancing projects by issuing green bonds requires special attention be paid to the elements of the offering documents.

We have prepared this document to present an overview of green bonds, describe the benefits for issuers and buyers, and identify potential areas of growth, all in order to offer practice tips for the drafting and reviewing of your green bond offering documents.

Many Shades of Green

There is no single universally accepted legal definition of “green bonds,” but all of the definitions that are in use today do share the fundamental idea that what makes a green bond “green” is that its proceeds are used to finance environmentally friendly projects. Beyond this simple definition, of course, there remain at least two questions: What percentage of the proceeds must be spent on environmentally friendly projects for the issue to be a green bond, and what counts as an “environmentally friendly” project?

“

Governments, companies and institutions issue green bonds to fund projects that are supposed to help the environment or climate, though the exact definition is open to interpretation. . .

–Green-Bond Sales Surge Toward Record as Borrowers Burnish Brands, [Bloomberg](#), Shelly Hagan, July 18, 2018

”

Issuers, buyers, and analysts will sometimes use the “Green Bond Principles,” (the “GBPs”) that were issued by the International Capital Markets Association (“ICMA”) in 2014 to determine the “greenness” of an issue or to determine whether an issue qualifies as a green bond. Even though not every issuance of green bonds purports to adhere to the Green Bond Principles, reference to the GBPs is useful for understanding what the market typically looks for in a green bond.

The GBPs were introduced as part of an effort to establish workable standards for green bond transactions. More specifically, in bringing forward the GBPs, the ICMA sought to assist

“The question of how issuers can convince investors of their environmental credentials is becoming an increasingly pressing one as the market for sustainable investment grows.”

Strict US market rules limit corporate sellers of green bonds,
Financial Times, Kate Allen, February 19, 2018

investors and
underwriters by
“emphasizing the
required transparency,
accuracy and integrity
of information that will
be disclosed and
reported by issuers to

stakeholders.” The GBPs are meant to do this by way of “promoting availability of information necessary to evaluate the environmental impact of . . . Green Bond investments. . .” and by “moving the market towards expected disclosures that will facilitate transactions.”

Even if a municipal green bond offering document does not expressly reference the Green Bond Principles by name – and many do not – the offering documents will usually demonstrate how the issue comports with at least several of the principles in substance. This is because the GBPs reflect the essential characteristics that are of most significance for the investor with regards to the “greenness” of the bond. The four Green Bond Principles are summarized as follows:

1. **Use of Proceeds**- 100% of proceeds must be used for “green projects”. Green projects are those which “contribute to environmental objectives such as: climate change mitigation, climate change adaptation, natural resource conservation, biodiversity conservation, and pollution prevention and control”
2. **Process for project evaluation and selection**- The issuer must be prepared to disclose how the project fits into the green projects category and how it fits into the issuer’s overarching objectives for sustainable and environmentally friendly development.
3. **Management of Proceeds**- The issuer must place the proceeds into a segregated subaccount, must account for all investment proceeds, and must be able to demonstrate that all proceeds have been used for the green project.
4. **Reporting**- Issuers shall keep readily available, up-to-date information (at least annually) on the application of funds, project development, and impacts of the funding.

The GBPs, taken together, reflect the investors' desire to understand as much as possible about the environmental impacts of the very projects that will be funded with the proceeds of green bonds. The offering documents for municipal green bonds in the United States typically address at least the Use of Proceeds and the Reporting principles directly, and the other two principles by at least implicit reference.

Municipal Green bonds do not all follow the same formula for explaining the basis for their respective "green" designations. For example, some municipal green bonds are "labeled," which means that they have been certified as meeting the green requirements of a third-party entity; and others are "unlabeled," meaning they are designated as green by the issuer, but not by any third party. Many bonds fall between these two categories. These bonds are not third-party certified, but the funded projects will receive certification for complying with certain standards, such as USGBC LEED certification or Energy Star criteria. It should be noted that even the terms "labeled" and "unlabeled" carry different meanings among the different market observers.

In the absence of a universally accepted standardization regime, the market encompasses, as noted by Bloomberg, "many shades of green," rather than a single model for such obligations to follow.

Possible Savings, Stability, and Non-Economic Utility

On the basis of savings or profitability alone, it is not immediately obvious why an investor would seek out green

Does Your Agency Issue Bonds for Any of These "Green Projects"?*

- **Renewable Energy** (including production, transmission, appliances and products);
- **Energy Efficiency** (such as in new and refurbished buildings, energy storage, smart grids, appliances and products);
- **Pollution Prevention and Control** (including reduction of air emissions, greenhouse gas control, soil remediation, waste reduction, waste recycling and energy/emission efficient waste to energy);
- **Environmentally Sustainable Management of Living Natural Resources and Land Use** (climate smart farm inputs such as biological crop protection or drip-irrigation; environmentally sustainable fishery and aquaculture; environmentally sustainable forestry);
- **Terrestrial and Aquatic Biodiversity Conservation** (including the protection of coastal, marine and watershed environments);
- **Clean Transportation** (such as infrastructure for clean energy vehicles and reduction of harmful emissions);
- **Climate Change Adaptation** (including information support systems, such as climate observation and early warning systems)

* Adapted from *ICMA Green Bond Principles*, June 2018

bonds. Green bonds, if anything, might actually cost the buyer more in terms of foregone yield than comparable municipal bonds.

A recent academic study estimates, for example, that unlabeled municipal green bonds produce a yield that is six basis points lower than comparable municipal bonds that are not designated as green bonds. What's more, according to the same study, labeled municipal green bonds tend to be sold at yields that are 12 to 18 basis points lower than comparable municipal bonds that are not designated as green.

These findings are supported by other studies that show that purchasers typically pay more in terms of foregone yield for municipal green bonds than with other bonds. It should be noted, however, that the notion of a "green-bond premium" is the subject of much debate. For each survey that suggests evidence of a premium, there is a bit of anecdotal evidence from the investment community that might indicate otherwise

Some public finance professionals believe that any perceived savings for the green bond issuer are based on factors other than the green bond designation. These factors might include that issuers of green bonds offer regular reporting on project completion, and that green bond issuers tend to have effective disclosure practices and solid credit ratings.

That said, there exists ample evidence that many municipal green bonds have sold at lower

"For the fiduciaries overseeing investments, climate change poses portfolio risks but also opens up new opportunities. This is because the necessary reduction in carbon emissions will require a fundamental change in the energy mix that underpins, to some extent, every investment in a portfolio."

Investing in a Time of Climate Change, Mercer, 2015.

yields than comparable bonds. To see where the motivation for purchasing lower yield investments might lay then, we should begin by looking to the first GBP, which is use of proceeds for "green projects." Green projects are defined in the GBPs as environmentally friendly

projects that tend to require less energy and lower carbon inputs than non-green projects. Green projects can include projects in areas such as: “climate change mitigation, climate change adaptation, natural resource conservation, biodiversity conservation, and pollution prevention and control.” Moreover, green projects share the common feature of having been designed to increase sustainability of the issuer’s operations and towards sustainability in a future that is more exposed to environmental change.

Seen from this perspective, investment in green bonds accomplishes three interrelated objectives which are important to a particular segment of investors. First, it allows investors to align their portfolios with the larger economic trends of lower energy and lower carbon intensity, and to invest with an eye towards sustainability in light of climate change. Second, it signals the investor’s commitment to principles of sustainability to its subscribers, who may be strongly motivated to invest in green projects for personal or ethical reasons. And third, municipal green bonds tend to have higher investment ratings than comparable municipal bonds, and as such, offer potentially greater security than other investments.

For the issuer, it is apparent that there are at least two significant advantages in designating bonds as green whenever possible. First, whether it is because of a “green bond premium” or some other related factor, a possible savings in yield payments of six basis points

“At a time of low carbon and fossil fuel energy prices, green bonds are highly attractive financial instruments that foster the environmental transition while enabling low-carbon project holders to expand their funding capacity . . . [T]here is a shortage of green bonds relative to the investment demand in several market segments and calls for operational and fiscal measures to increase the pipeline of green bonds issued.”

Is There a Green Bond Premium? The yield differential and conventional bonds. Research Paper, Oliver David Zerbib, May 5, 2018.

for unlabeled bonds can be of significant value for the issuer, particularly in a time of rising interest rates. An issuer may need to spend between \$10,000 to \$50,000 for third-party certification, as well as an additional amount for registration with a green fund index, to sell a labeled bond. Labeled bonds may sell as yields that are 12 to 18 basis points lower than comparable bonds. Accordingly, the value of selling an issue as labeled as opposed to unlabeled

would depend on the project. The second benefit is that the use of green bonds signals to the public the issuer's commitment to sustainable development. The add-on effects of such a display of commitment are potentially numerous.

Green Growth

The first "green bond" was issued by the European Investment Bank in 2007. From 2007 to 2013, most issuers of green bonds were European Supranational entities. Municipal issuers in the United States and public entity-issuers in the European Union, possibly spurred by the Paris Accords, led the market in issuance in 2014 and 2015. Emerging market economies, particularly China, took the lead in green bond issuances in 2016. Currently, the U.S. and its municipal issuers lead the market with approximately \$16bn in issuances for the first half of 2018, followed by China with approximately \$9bn in issuances.

Within the U.S., issuers come from 31 different states. To date, Texas has at least two issuances of green bonds – one from the University of Texas and the other from the Fort Bend Independent School District. Each of these issuances is for the construction of LEED certified facilities, and neither of these bond series are certified as green by a third-party entity.

According to a recent analysis by the Climate Bonds Initiative, most U.S. municipal issuances are for water projects (64%), followed by, in order, transportation (30%), and then waste, land use, and then energy. The same analysis states that of the water related bonds, 60% of proceeds are used for flood protection; 24% for climate resilience; and the remainder is split between fresh water supply and wastewater treatment and management.

Municipal issuances, as of 2016, accounted for approximately 2% of the municipal market, and about 25% of the green bond market; but according to green bond analysts, there are areas for considerable growth. According to these observers, one major area for growth is municipal bonds that are for green projects but currently are not designated as such. The idea is that the number of issuances would grow if more issuers were to make the effort to identify which of their upcoming projects are "green projects," and then issue the bonds for those projects as

such. The types of projects that might fit under this category include those that relate to water and flood control, and as shown with the UT and Fort Bend ISD bonds, the construction of energy-efficient facilities.

Another potential area for growth, according to observers, is in the refinancing of bonds that have been issued for green projects but not designated as such. Along this front, there is an estimated \$250m of outstanding candidates for refinancing as green bonds because of the original green-project focus of the underlying new money bonds.

There are many indications that the general green bond market will continue to grow in the U.S and globally. The second quarter of 2018 saw \$47bn of issuances, which was a 21% year-on-year increase. Even in light of the general worldwide slowdown in bond trade, Moody's and S&P both expect the green bond market in 2018 to exceed the 2017 total of \$161bn by between \$40bn to \$90bn.

Green Bond Disclosure Considerations

TIPS FOR DRAFTING OFFERING DOCUMENTS

- "Translate" technical terms and descriptions for use by a general audience.
- Describe why the project is green, but take care to not inadvertently oversell.
- Ensure that the entire team is familiar with the representations made in the offering documents and that the project is viable.
- Carefully plan for fulfilling any reporting obligations that are expected by green bond investors.

Several analysts have noted that the growth of the green bond market might be hindered by the lack of a legal definition and regulatory framework for green bonds. Until there is an established structure, issuers and underwriters must continue to take it upon themselves to determine what disclosure is required for a green bond transaction.

It is up to the issuer and the underwriter to determine how far the issuer will want to go in framing the bonds in terms of the Green Bond Principles. For example, it is not uncommon for the offering documents for unlabeled issues to

reference the GBPs, but not expressly address each of the four principles. Many offering documents describe the project and the reporting methods directly but reference the process for project selection indirectly, if at all, and only reference the management of proceeds either indirectly or through the language of the bond or the authorizing act.

In preparing offering documents, there are four key points which issuers should keep in mind. First, when describing the project, the issuer should account for the fact that certain technical terms, such as “mitigation,” and “adaptation,” may have one meaning for engineers, another meaning for investors, and yet another meaning for climate policy professionals. As such, the issuer must be certain to “translate” any technical terms used to describe the project for understanding by a general audience.

Second, the issuer must explain why the project is suitable for green bond financing, but must do so in a way that does not oversell the project or imply obligations that cannot be met by the issuer. It is important to remember that Investors will rely on the details of the description in evaluating whether the project is a good fit for their green bond portfolio.

Third, as with any bond transaction, the issuer will want to ensure that all of the key players in the green project have reviewed and are familiar with the description of the project and with the description of the use of the proceeds in the offering documents. Moreover, the issuer will need to be absolutely certain of the viability of the project and of the likelihood of successful implementation before incurring obligations relating to material points of the transaction. For example, if the funded project is intended to produce a 10% offset in carbon associated with power production, the issuer will need to confirm with its engineers that the goal is attainable and likely.

A fourth consideration is the reporting on the progress of the green project and of its impact. As noted, green bonds are unique in that investors are concerned with monetary as well as non-monetary utility. It is not unusual for green bond investors to want to be able to verify that not only will debt service payments be made on time, but also that the project was completed and made a positive impact. Accordingly, issuers should plan to have a method for providing

updates on their funded projects and should be prepared to commit to maintaining the described reporting schedules.

Conclusions and Next Steps

The nascent green bond market is a piece of a larger concerted effort by certain investors to transition the global economy towards sustainability in the face of climate change. States and local governments are at the forefront of the development of new strategies for addressing the challenges of climate change, and green bonds are a natural fit in that effort.

Hopefully, this summary will be useful to you as you consider whether your next project may qualify for green bond financing, and how you might best describe your project to potential investors. The market is still growing and your next project very well might help shape the standards that will be used in future green bond transactions.

Please feel free to contact Gregory Miller at our Austin office if you would like to discuss how green bonds might be used to finance your future projects.

